SUPREME COURT, U. S.

OCT 23 1975

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-617

RAYMOND GREENBERG AND MARILYN GREENBERG,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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October 1975

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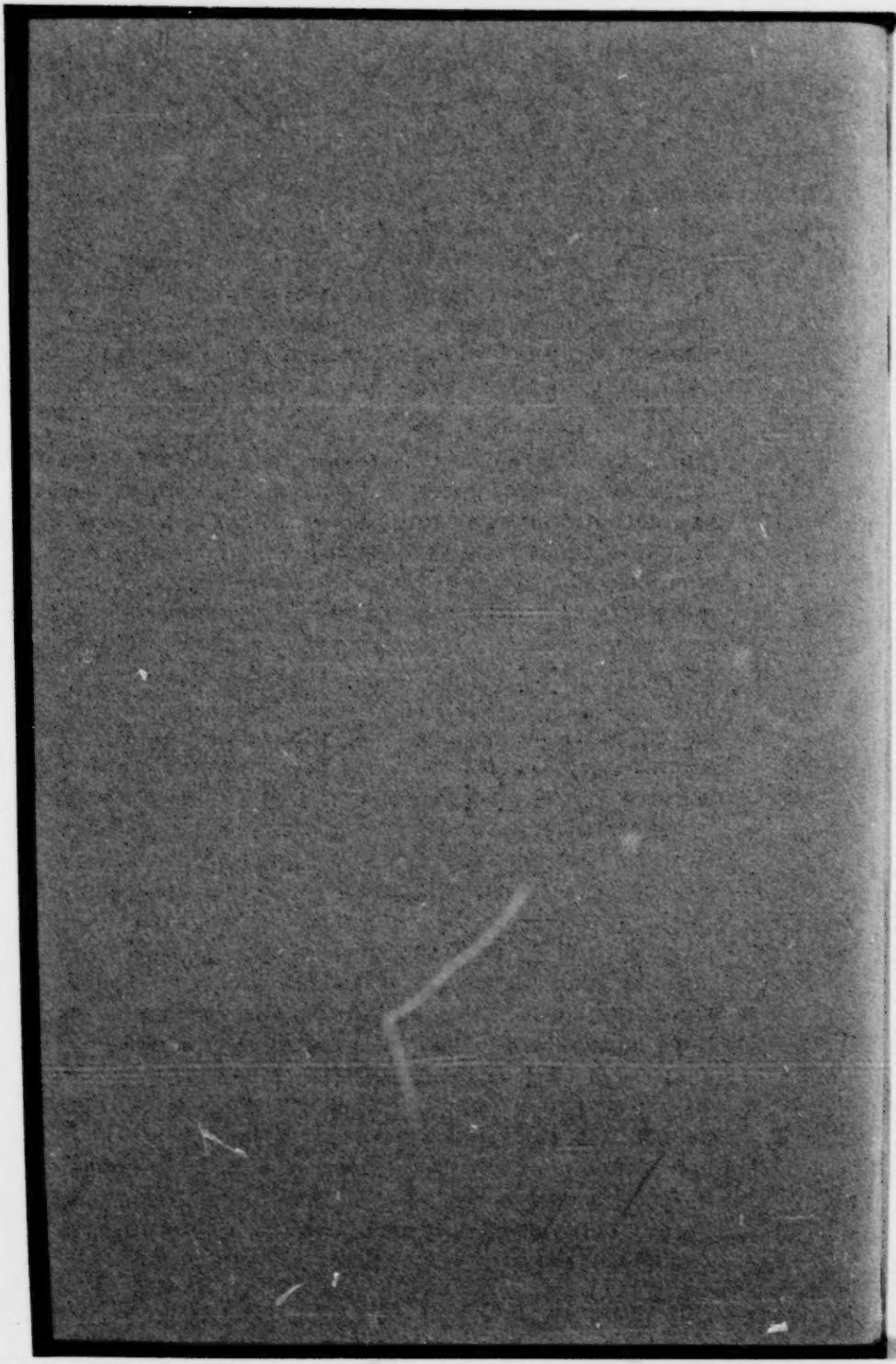

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Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit, entered in the above-entitled case on July 28, 1975.

CITATION TO OPINIONS BELOW

The findings of fact and opinion of the United States Tax Court printed in Appendix B hereto, *infra*, pp. 3a-33a are reported in 62 United States Tax Court Reports at pages 331-351. The opinion of the Circuit Court of Appeals, printed in Appendix B hereto, *infra*, pp. 34a-35a is as yet unreported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 28, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

1. When four corporations carrying out *some* separate business activities are liquidated, and a fifth corporation remains unliquidated, can the resulting distributions be lawfully treated as dividends rather than capital gains?

2. Does a Tax Court subpoena, pursuant to which an Internal Revenue agent acquires documents for taxable years that have previously been examined, violate the provisions of Section 7605 (b) of the Internal Revenue Code, limiting the Commissioner's power to examine a taxpayer's records to one such examination for each taxable year?

STATUTES INVOLVED

The statutory provisions involved are Sections 331(a), 1202 and 7605(b), Title 26, United States Code (Internal Revenue Code). These provisions are printed in Appendix A, *infra*, pp. 1a-2a.

STATEMENT

The jurisdiction of the United States Tax Court was invoked pursuant to Section 6213 of the Internal Revenue Code; the jurisdiction of the Court of Appeals to review the decision of the Tax Court is based on Section 7482 of that Code.

This case arose from a proceeding in the Tax Court which had sought redetermination of a deficiency as-

serted by the Commissioner of Internal Revenue (hereinafter referred to as "Commissioner") with respect to taxpayers' Federal income tax returns for the calendar years 1966 and 1967. Following the filing of the petition, answer and amended answer, trial was held before the Honorable Irene F. Scott, Judge. A pretrial hearing on taxpayers' motion to quash subpoenas *duces tecum* was held by the trial judge and resulted in an order which granted the motion in part and denied it in part. Since the parties had agreed to disposition of several of the adjustments in tax liabilities initially raised in the pleadings, the Tax Court was called upon to decide the sole question of whether the corporate liquidations in 1966 resulted in ordinary income or capital gain to the taxpayers. The Tax Court resolved that issue in favor of the Commissioner and entered its decision accordingly. The Court of Appeals affirmed in a *per curiam* opinion.

The facts related to the transaction in dispute are substantially undisputed. They show that as of May 20, 1966, taxpayer Raymond Greenberg (hereinafter referred to as "Greenberg") owned one half of the capital stock of five corporations, known as Colt Development, Inc., Colt Builders, Inc., Colt Homes, Inc., Colt Properties, Inc. and Colt Contractors, Inc. Greenberg also owned a 50% partnership interest in a partnership called Gerasi Associates from which the Colt corporations had from time to time acquired land and rented some of their equipment. The remaining capital stock in the Colt corporations and balance of partnership interest in Gerasi were owned by George Revitz. Pursuant to an agreement dated May 20, 1966, Revitz sold his one half interest in Gerasi to Greenberg and Colt Development, Inc. also redeemed Re-

vitz' stock interest in that corporation. Shortly thereafter, Greenberg and Revitz caused the other four Colt corporations to adopt resolutions for their complete liquidation whereby the assets of such corporations were to be distributed equally to Greenberg and Revitz. The amount of distribution with respect to each corporation appears in the findings of the Tax Court. The total distribution of $213,994.53 was reported on the taxpayers' joint income tax return as a capital gain. In accordance with that method of reporting these transactions, the taxpayers reduced that total by $106,997.27 representing the deduction under § 1202 of the Internal Revenue Code applicable to disposition of capital assets owned for more than six months, and included the balance in their gross income for the taxable year 1966. The Commissioner disallowed the § 1202 deduction holding the distributions to be reportable as ordinary income and the Tax Court upheld that determination.

The evidence before the Tax Court consisted of testimony and a large quantity of documents, the authenticity of which was stipulated, but most of which were admitted over the taxpayers' objection.

The taxpayers' direct testimony consisted of evidence which showed that their accountant had been served with a subpoena to appear at the trial of this case and to produce numerous books and records. The testimony further revealed that in substantial part the records referred to had been previously examined by the Internal Revenue Service. The accountant testified that he turned the books over to the Internal Revenue Agent as a result of the subpoena and that he did so at the direction of taxpayers' counsel. The agent himself testified that he had been assigned to

assist counsel for the Commissioner in this case and that the purpose of the examination conducted by him was "to show that the five corporations are actually one single operation." Rebuttal testimony from Greenberg showed that in connection with the subpoena served on him, he made seven file cabinets of records available to the agent and that some of these materials extended back as far as 1958.

The evidence showed that the five Colt corporations were organized in 1959 and 1960 by Greenberg, Revitz and a third person who disposed of his stock ownership in 1964. The various corporations at all relevant times until May 1966, were engaged in the construction of single family dwellings in Montgomery County, Maryland. After the liquidation of four of the corporations, Colt Development, Inc. continued with these activities, but constructed a substantially fewer number of houses than the five corporations had done prior to that time.

The five corporations were initially formed by the same three persons, one of whom was Greenberg. Their corporate charters were identical and their bylaws were essentially similar. In 1958, the same individuals formed a partnership (Gerasi) which acquired the land on which the Colt corporations built homes and transferred the same to those corporations, as construction progressed. Each of the five corporations engaged in its own construction activities, although so-called project costs were for the most part billed to and paid by Colt Development, Inc. and thereafter allocated among the other corporations. These allocations were based on the number of homes built by each corporation in a given year. As the Tax Court noted, actual construction costs, after building permits were

obtained and lots were transferred, were generally paid by the individual corporations. The five corporations untilized common office personnel and accounting procedures and incurred a number of expenses for their common benefit. Among those were legal and accounting, auto expenses, rent and office salaries. These expenses were paid by Colt Development, Inc. and subsequently allocated among the individual corporations. Advertising for sales of homes was similarly carried out in common, but the sales representative in two of the subdivisions testified that contracts for the sale of homes were entered into in the names of the separate building corporations. Construction contracts were entered into between the individual corporations and subcontractors either jointly or separately and, on occasion, with Colt Development, Inc. alone. Construction loans were made with respect to the individual homes built and were disbursed to the separate corporations, although the individual stockholders were usually liable on such loans.

Each of the three initial organizers of the five corporations including Greenberg testified on rebuttal. They testified that the principal reasons for the formation of the separate corporations were limitation of liability for negligence suits, subcontractors' claims, warranties made to purchasers and financial risks. Greenberg further testified that after May 1966, he decided to carry on his building activities through only one corporation because of a substantial reduction in the number of homes constructed; he estimated that he had built fewer than 100 homes since that time.

The taxpayers requested the Tax Court by motion to include the substance of the aforementioned rebut-

tal testimony, and of the testimony relating to inspection of records by the Internal Revenue Agent, in its findings. That motion was denied.

REASONS FOR GRANTING THE WRIT

I

This case is one of first impression. It represents the results of an attempt by the Commisioner—now sanctioned by both the Tax Court and the Court of Appeals—to treat distributions in complete liquidation of a number of corporations as being equivalent to a dividend, merely because of the previously related activities to another corporation which remained active. The lower courts upheld these actions on the part of the Commissioner, not because they are supported by the provisions of any statute, but as a consequence of the finding, that the four separate corporations were in effect "sham" entities and should be regarded as part of the single unliquidated business enterprise that continued to exist without interruption. The Court of Appeals in affirming the decision of the Tax Court in this case, has upheld a result that vests powers in the Commissioner of Internal Revenue that are far beyond those that are delegated by the Congress. To imply a grant of authority to disregard corporate entities under the facts of this case, presents a position that is totally at variance with the previous decisions of this Court and, we submit, is of such far-reaching public importance as to make review by this Court both desirable and appropriate.

Although initially having made the bare assertion that the distributions from the Colt corporations received by Greenberg were taxable as ordinary income

rather than capital gain, the Commissioner shortly before trial amended his answer to add two alternative theories. He stated that capital gain treatment should be denied either because the liquidated Colt corporations lacked a separate and independent business purpose, or because in accordance with the provisions of § 269 of the Internal Revenue Code, Greenberg and his associates had acquired their interests in the separate corporations for the purpose of evading or avoiding Federal income taxes. Of course, the first theory was adopted by the Tax Court and its decision rests on it. The alternative contention advanced is briefly referred to by the Tax Court, but no finding was made that § 269 applied, nor that the principal purpose of evasion or avoidance in fact existed. Accordingly, it may be assumed that the Tax Court rejected the alternative theory of § 269 and we are, therefore not addressing ourselves to it.

It was undisputed that Greenberg in May 1966 owned one half of the outstanding capital stock of the five Colt corporations and that at the time referred to, four of those corporations terminated their separate existence. It is also uncontroverted that one of the corporations, Colt Development, Inc. continued in the construction business after that time. Since the distributions received by Greenberg which are disputed here were of all of the assets of the four corporations, we submit that they fall squarely within the provisions of § 331 of the Internal Revenue Code. The pertinent portion of that section reads as follows:

"*Sec. 331. Gain or Loss to Shareholders in Corporate Liquidations.*

(a) General Rule.—

(1) Complete liquidations.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock."

Inasmuch as no one questions that the capital stock in the four corporations was held for more than six months, it follows that the deduction of one half of the gain provided in § 1202 of the Code is applicable. The Tax Court recognized that if the transaction in question was governed by the aforementioned statute, the taxpayer must prevail. However, it concluded otherwise holding that the four liquidated corporations lacked a separate business purpose apart from the unliquidated corporation, and that, therefore, the distributions received are to be taxed as dividends.

In considering the applicability of Section 331, it should first be noted that nothing contained in this statute, or in any regulation promulgated by the Commissioner, in any way suggests that its provisions are available only to those taxpayers whom the Commissioner finds eligible. There is no element of discretion conferred on the Internal Revenue Service which would make these distributions qualify or not qualify as capital gains depending on whether they pass the test of meeting certain factual criteria. The Congress has established a single prerequisite for the treatment of liquidations under this statute, and that is the prerequisite of completeness. We are not dealing here with the allowance of deductions, which have often been described as matters of legislative grace. There

is no requirement or stipulation that could extend these provisions of law only to those corporations the formation of which was caused by motives the Commissioner approves. The entire record demonstrates that these corporations were distinct legal entities which had a long history of separate recognition by both the Government and the taxpayers. We submit that the Tax Court's inquiry should have ended here and the decision for the taxpayers should have followed. Instead, however, the lower court entered into an analysis of the facts which may have been relevant to a determination of whether related corporations are entitled to multiple surtax exemptions, but has no relationship to a resolution of the single question of whether the four corporations had been subjected to a complete liquidation.

We hasten to acknowledge that corporations which are straws, so-called "dummies," or otherwise have purely a paper existence, need not be recognized for tax purposes. A corporation, to be entitled to recognition for tax purposes, must carry out *some* business function. The frequently-quoted words in *Moline Properties* v. *Commissioner;* 319 U.S. 436, 63 S. It. 1132, 87 L. Ed. 1499 (1942) are meaningful here:

> "The doctrine of corporate entity fills a useful purpose in human life. Whether the purpose be to gain an advantage under the law of the State of Incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

In an opinion by Judge Learned Hand, in *National Investors Corporation* v. *Hoey* (2nd Cir. 1944) 144 F. 2d 466, 467, the same principle is stated as follows:

> ". . . whatever the purpose of organizing the corporation, 'so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.' 319 U.S. 439, 63 S. Ct. 1134, 87 L. Ed. 1499. That, as we understand it, is the same interpretation which was placed on corporate reorganizations in Gregory v. Helvering, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596, 97 A.L.R. 1355, and which has sometimes been understood to contradict the doctrine that the motive to avoid taxation is never, as such relevant. In fact it does not trench upon that doctrine; it merely declares that to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning."

The four liquidated Colt corporations clearly carried out "some" business functions within the meaning of these decisions. In fact, their activities were substantial, as the record demonstrates. They took title to lots, arranged to improve them, paid for construction, conveyed the completed homes to buyers and issued their own individual warranties.

There is not the slightest doubt that the business which Greenberg and his associates conducted through the means of the five corporations had many interrela-

tionships and common elements. They transferred land from a partnership organized by the same individuals, shared development expenses and paid many administrative costs through the medium of a single corporation and later allocated them among the others. But there were many important and valid business reasons that prompted the organizers to select separate corporations for doing business. According to the unrebutted testimony, they were both conscious and concerned about the risks inherent in the construction of homes. They had not previously undertaken projects of this magnitude and they were genuinely apprehensive regarding the hazards and potential disputes in dealing with purchasers as well as large numbers of subcontractors. The fact that in the course of exercising this business judgment, the managing officers of the Colt corporations would utilize a variety of common services, does not destroy the valid business purpose of limiting liability. *Southern Dredging Corp.*, 54 T. C. 705 (1970). It is difficult to comprehend the Tax Court's conclusion that the corporations were adequately insured against tort liability and that, therefore, the separateness of the corporations provided no valid business reason. It would seem to have been a matter of which the Tax Court could have almost taken judicial notice that, no matter how adequate insurance coverage may seem, diffusing the considerable hazards of the construction business among separate corporations necessarily has to be a business advantage. The Tax Court relies most strongly on its own decisions in *Aldon Homes*, 33 T. C. 582 and *Shaw Construction Company*, 35 T. C. 1102. Both of these cases present the classic "multiple corporation" issue in which the use of individual surtax exemptions is the principal tax benefit involved. In both instances, the

Court found that the individual corporations had no viable existence for tax purposes and held that their gross income should be taxed as though they were one entity. The statutory basis relied on in *Aldon* and *Shaw* was § 22(a) of the 1939 Internal Revenue Code which is the broad, almost all-inclusive, definition of "gross income," now contained in § 61(a) of the 1954 Internal Revenue Code. Apart from the fact that the Commissioner in his pleadings did not rely on § 61(a), we find the emphasis on *Aldon* and *Shaw* misplaced for other reasons. We submit that, as has been pointed out above, sound business reasons for separate corporations existed in the instant case. More importantly, however, we contend that a different standard must be used to decide the shamness question when the Commissioner seeks to deny the taxpayer the benefits of a statutory complete liquidation, as compared with the conclusion that the multiple gross income of several corporations is to be regarded as being that of a single enterprise.

It may well be that taxpayers such as those in *Aldon* and *Shaw* forfeit the benefits of separate surtax exemptions when they operate a multiple enterprise in this manner. However, here we are not dealing with the gross income of the corporations. We are faced with an attempt by the Commissioner to revoke or suspend a specific section of the Internal Revenue Code that prescribes the tax results of a complete liquidation. We submit that a different test of shamness applies here. Here the rule of *Gregory* v. *Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935) should be applied. This Court in *Gregory* disregarded the corporate entity because it found that the corporation had come into being without *any* business purpose

whatever for the sole purpose of taking advantage of certain reorganization provisions. There was an unmistakable and direct connection between an unneeded corporate entity and a predetermined tax result. We have no findings by the Tax Court that would sustain a shamness conclusion as in *Gregory*, predicated on the existence of pre-arranged tax scheme. A finding under § 269, which requires a tax evasion or avoidance purpose as an indispensable element, would pose a different problem, if the record showed a specific violation of that statute. However, the Tax Court reached no such conclusion. In fact, it barely mentions the Commissioner's § 269 argument and seemingly rejected it by clear implication.

There is no undefined, residual authority delegated to the Commissioner whereby he can arbitrarily strike statutes, or nullify their operation at will. It is significant that when the tax laws pertaining to multiple corporations were revised as part of the 1964 Revenue Act, the legislative history is silent on any intent to limit the provisions of § 331 upon liquidation of a member of an "affiliated group." It is apparent from the legislative history of the 1964 Act that Congress was fully aware of the statutory weapons available to the Commissioner through the use of Sections 269, 1551 and 482, whenever he perceived an allegedly improper use of multiple corporations. See: Senate Report to accompany H. R. 8363; 88th Cong. 2nd Sess. U. S. Code Cong. & Adm. News, pp. 1823-24.

The Tax Court appears to suggest that the benefits of § 331 are available to only those taxpayers who can prove that the liquidated corporation was not subject to challenge because of some possible tax advantage as a multiple corporation. We submit that this approach

violates all principles of interpretation that have been long accepted in this field. Not only should tax statutes not be extended beyond their clear meaning, but in case of doubt they should be most strongly construed against the Government. *Gould* v. *Gould*, 245 U.S. 151, 38 S. Ct. 53 (1917); *B & M Co.* v. *U.S.* (5th Cir. 1971), 452 F. 2d 986. As this Court has pointed out, the Congress has drawn meaningful distinctions between tax consequences of transactions depending on whether they occur at the corporate or shareholder level. *U.S.* v. *Cumberland Service Co.*, 338 U.S. 451, 70 S. Ct. 280, 94 L. Ed. 251 (1950). In the same way, the restrictions that can be lawfully imposed on multiple corporations cannot, without statutory authority be translated into new and different individual tax levies. The Tax Court noted that it had found no case dealing with the precise issue here presented. However, it referred to the case of *Walter L. Morgan*, 33 T. C. 30 (1959), reversed on other grounds (3rd Cir. 1961) 288 F. 2d 676. That case actually supports the taxpayer's position inasmuch as it was there held that the fact that a corporation's income was allocated to another corporation, did not deprive the stockholders of their right to treat gain from the liquidation of the first corporation as a capital gain. In reaching this result in *Morgan*, the Tax Court particularly emphasized that "disregard of corporate entities is an extraordinary legal technique" (33 T. C. at p. 41).

In the final analysis, it appears that what the Government seeks is a kind of punitive action that would impose serious monetary penalties on those who have utilized multiple corporations for tax purposes. To the extent that those penalties depart from specifically enacted statutes, they are, of course, invalid. Under the

prior rulings of this Court, and the decisions of many lower courts, the disregard of the corporate entity is indeed an extraordinary step. In our view, that step becomes all the more serious when its result is the effective suspension of an entire section of the Internal Revenue Code by converting capital gains to ordinary income. We submit that only the Congress can fashion such measures and consequences.

II

The Tax Court rejected taxpayers' argument that under the pretext of serving a subpoena *duces tecum*, the Commissioner had in effect conducted an illegal second examination of the corporations' books and records. Section 7605(b) of the Internal Revenue Code prohibits such a second examination, unless preceded by a written notice from the Commissioner, or requested by the taxpayers. No one has contended that the Commissioner gave the aforementioned notice, nor has it been denied that the records examined were reviewed for the second time. The Tax Court is simply in error in concluding that Greenberg had "in effect requested" the Internal Revenue Agent to inspect his files. The record shows that, following a pretrial hearing at which the Tax Court Judge quite properly encouraged the parties to stipulate undisputed facts, access to such records was given by both the accountant and Greenberg for that particular purpose. What took place, however, was the conduct of a giant fishing expedition in which the Commissioner's agent spent almost a full day searching for evidence calculated to show "that the five corporations are actually one single operation." We submit that the fact that the persons summoned could have produced the records at

trial is of no consequence. What the Government engaged in purely and simply was a second audit. Section 7605(b) prohibits such actions under these circumstances, and it does so without regard to whether the inspection is conducted for purposes of a trial, or otherwise. Mr. Zoslow was just as surely an agent of the Commissioner whether he gathered evidence for an assessment or to furnish assistance to Government counsel. Greenberg was simply lulled into cooperating with the agent in the mistaken belief that he was complying with the subpoena. What has taken place is a misuse of the Commissioner's power of examination in a manner which the above-mentioned statute seeks to prevent. *Pacific Mills et al* v. *Kenefick* (1st Cir. 1938) 99 F. 2d. 188. This Court has left no doubt that compliance with the prerequisite of notice under § 7605(b), in the absence of a taxpayer request, is an absolute prerequisite. *U.S.* v. *Powell*, 379 U.S. 48, 85 S. Ct. 248 (1964). Disregard of the statute is a proper basis for setting aside the deficiency. *Reineman* v. *U.S.* (7th Cir. 1962), 301 F. 2d 267. Accordingly, the Tax Court should have sustained the taxpayers' objections to introduction of evidence acquired in the above-described manner.

The limitation that the statute places on the Commissioner's power to examine taxpayers' records is founded on important public policy considerations, as the *Powell* decision makes clear. The record in this case demonstrates that the Internal Revenue Agent had a predetermined, but uncommunicated purpose to use the subpoena as a device to obtain access to the previously inspected books and records. In sanctioning this procedure, the courts below have allowed a mere formalism to thwart an unambiguous Congressional intent.

CONCLUSION

For the reasons heretofore stated, petitioners submit that the writ of certiorari should be granted.

Respectfully submitted

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October 1975